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SBA

# Business Basics

# Asset Management

A Self-Instructional Booklet
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U.S. Small Business Administration
Office of Management Assistance

SBA 1.19:

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

S/N 045-000-00175-0

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# ASSET MANAGEMENT
## Instructor's Guide Sheet

This booklet contains:

1. Assets -- Investment/Return
2. Asset Classification
3. Liquidity
4. Asset Mix
5. Problems in Asset Management

Supplementary Instruction:

1. Have the client secure copies of recent industry averages, through trade association or library sources, and compare the distribution of the client's assets with the averages.

2. Identify any apparently excessive investments based upon comparison with industry averages. Recommend supplementary instruction from the modules on accounts receivable, inventory management, and fixed assets as indicated.

3. Relate the subject matter to other assets that appear on the client's balance sheet which are not specifically covered in this and related modules. Such other assets might include securities, prepaid expenses, loans to officers or employees, unamortized organization expense, and goodwill.

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# INTRODUCTION

## Managerial Responsibility

As the owner of a small business, you are called upon to manage many aspects of your operation -- personnel, facilities, equipment, capital, sales, expenses, purchases, etc. Unlike the owners and chief executive officers of large corporations where many managerial responsibilities can be delegated, you must have an intimate knowledge of virtually every phase of the operation.

In this module, we will concentrate on one particular phase of your managerial responsibility, management of assets. This managerial responsibility is too often overlooked by small business owners. In the pressure of day-to-day activities, the owner's attention is focused upon building sales, solving production problems, correcting equipment failures, controlling expenses, and dealing with personnel and customer relations. Faced with all these problems, owners find little time to resolve those problems that they consider less urgent, such as asset management. The first time asset management commands serious attention is when a serious problem arises, and without planning and foresight, it almost certainly will. This is as true in growing, profitable businesses as it is in marginal businesses. In fact, the demands of a rapidly growing, profitable operation will often create the most severe problems in asset management.

## Your Assets

In most small businesses, the principal assets are among the following:

- Cash -- petty cash, undeposited receipts, the checking account balance, and cash equivalents such as certificates of deposit or government bonds.
- Accounts receivable -- amounts owed to you by customers.
- Inventory -- goods or services that you have purchased for resale to customers.
- Fixed assets -- plant, property, equipment, motor vehicles, and other physical assets that will be used in your business for a relatively long period of time.

Some businesses may not require all of these assets. Many businesses have no need to own plant, property, or equipment. Personal service businesses may need no inventory. Retailers and restaurants may have no credit sales and, therefore, no accounts receivable. However, it is difficult to imagine a business that can long survive without cash.

## Objectives of Asset Management

What are the purposes of asset management? What can you realize from sound asset management? How will your business profit by it? The objectives of asset management can be summarized as follows:

. Protect your investment in assets from fraud, misuse, or theft.

. Minimize waste, expenses, and costs.

. Maximize usefulness, efficiency, and profit.

. Determine future asset requirements so that you can develop financial plans on a sound and continuing basis rather than act only when crises occur.

## About This Booklet

This is the introductory booklet in a series related to the topic of asset management. The remaining booklets deal with specific groups of assets as follows:

. Credit Policy and Procedures. How to control your accounts receivable in order to minimize the possibility of bad debts and guard against excessive commitments of your capital to receivables.

. Inventory Management and Control. How to maintain inventory at levels that will be sufficient for your sales or production needs without tying up your dollars in slow-moving inventory.

. Managing Fixed Assets. How to obtain the use of the facilities or equipment that you need to conduct your business with a minimum commitment of your own funds so that you reduce the risks inherent in such longer term investments while enjoying most of the benefits associated with ownership.

This series of booklets will also provide you with a basis for determining future asset requirements, a topic that will be discussed in more detail in another series of modules. Protection of assets from theft, fraud, and misuse will be covered elsewhere.

This series of booklets concentrates upon those functions that are the continuing managerial responsibility of the small business owner, who must be sure that the business' money is invested where it will do the most good in producing profit.

## ASSETS

From a financial standpoint, an asset is defined as something of value owned by a business. The key word in this definition is "owned." Many things that have value to a business are not necessarily assets from a financial standpoint. For example, the services of a key employee are obviously valuable to the business, but these services are seldom owned by the business. A gasoline station on a heavily traveled highway would probably consider its location an asset, but the location would not ordinarily be considered an asset from a financial standpoint.

### Asset Classification

Assets are classified as follows:

- Current assets. Cash and other assets that will be converted to cash within a period of one year. This classification includes accounts receivable, which normally are collected within a year, and inventory, which any business should expect to sell within a year.

- Fixed assets. Tangible property such as buildings, equipment, and motor vehicles which will be used in a business for a period of more than one year.

- Other assets. Any assets that do not fall into either of the preceding classifications. Normally, this includes any intangible assets that will not be converted to cash within one year. Since they are intangible, they cannot be classified as fixed assets. Since they will not be converted to cash within one year, they cannot be considered current assets. Typical examples of other assets are an investment in another business, licenses purchased by the business, and any amount owed to the business that will not be paid within a one-year period.

NOTE: Cover the correct answers and write your answers on a separate piece of paper (or in the book). Check your answers and review weak areas. Do all the exercises the same way.

1. An asset is something of value (OWNED/USED) by a business.

---

OWNED

---

2. A contractor leases a bulldozer for a three-year period. The bulldozer would be considered one of the contractor's assets. (TRUE/FALSE)

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FALSE (It is not owned by the contractor.)

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3. A retailer hires the most highly respected buyer in the business. The buyer's skill would be considered one of the retailer's assets. (TRUE/FALSE)

---

FALSE

---

4. To be considered an asset, a thing must have value and be _____ by the business.

---

owned

---

5. Cash and other assets that will be converted to cash within one year are considered _____ assets.

---

current

---

6. Tangible assets that will be used in the business for a period greater than one year are considered _____ assets.

---

fixed

---



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7. An amount owed to a business by a customer is a (CURRENT/FIXED) asset.

---

CURRENT

---

8. Inventory is a (CURRENT/FIXED) asset.

---

CURRENT

---

9. Amounts owed by customers are called _____.

---

accounts receivable

---

10. Goods or services acquired by the business for resale to customers are called _____.

---

inventory

---

11. A typewriter owned by a business for its own use would be considered a (CURRENT/FIXED) asset.

---

FIXED

---

12. A typewriter purchased by a business for resale to a customer would be considered a _____ asset. Why?

---

current (Since it was purchased for resale, it would be included in inventory.)

---

13. A typewriter leased by a business would:

a. be considered a current asset
b. be considered a fixed asset
c. not be an asset

---

c. not be an asset

---

14. An asset that is neither tangible nor convertible to cash within one year would be classified as a(n) _____ asset.

---

other

---

15. Classify each of the following as current, fixed, or other assets:

a. an office copier purchased for resale to a customer _____

b. an office copier purchased for use in the business _____

c. an amount loaned to an employee that will not be repaid for 18 months _____

---

a. current
b. fixed
c. other

---

* * * * *



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## Liquidity

The liquidity of an asset is the rate at which it will be converted to cash. Some assets are more liquid than others. For example, the accounts receivable you have today, amounts owed to your business by your customers, should be collected (converted to cash) within a few months. Your inventory may not be sold for several months. If it is sold on credit, the account receivable created by the sale will not be collected until some later date. Therefore, inventory is usually considered less liquid than accounts receivable because of the longer time required to convert it to cash.

### Importance of Liquidity

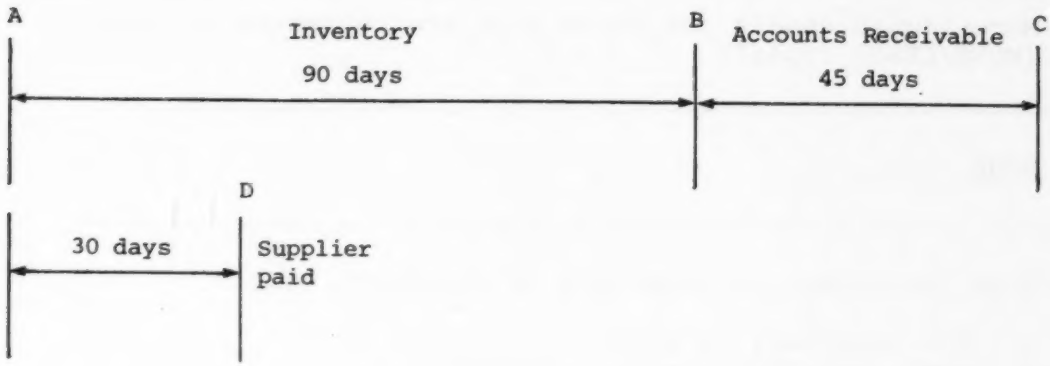
To help you understand the importance of liquidity in generating sales and profit, consider the case of The Right Bike Company which buys old bicycles for $25, spends about $5 for parts, fixes the bicycles, paints them, and then sells them for $50. With each $50 sale, Right recovers the original $30 investment and earns a $20 profit. From the time Right buys the bicycle and the parts, the bicycle is in Right's inventory and the $30 investment is tied up. The $30 is not available to purchase another bicycle.

When Right sells the bicycle and recovers the $30 investment, Right can then buy another used bicycle and the parts needed to fix it. If it takes Right 10 days to find a customer for each bicycle, Right will be able to make only 36 (360 ÷ 10) sales for $720 (36 x $20) profit a year. However, if Right can turn the inventory over more rapidly by selling each bicycle within 5 days, Right will be able to buy and repair 72 bicycles a year for a total profit of $1,440. In other words, Right will have turned over the initial $30 investment 72 times by finding customers more quickly so that bicycles remain in inventory for only 5 days.

### Turnover

The diagram below illustrates the same concept in a more typical business environment. At point A, the business acquired goods for inventory. Assume that the goods remained in inventory for 90 days until they were sold at point B. When sold at point B, an account receivable was created which was collected at point C, 45 days after the sale. This resulted in a total of 135 days (90 + 45) between the inventory purchase and the time the business

recovered the investment in inventory. This commitment was somewhat reduced by the fact that the business did not pay the supplier until point D, 30 days after the purchase. Therefore, the business had to wait 105 days (135 - 30) from the time that cash was disbursed to acquire the asset to the time when the cash was recovered.




During this period, the money tied up in inventory and accounts receivable was unavailable to the business to be used for other purposes. If the business could have turned the inventory and accounts receivable over more rapidly, there would have been more opportunities to use those invested dollars to acquire more inventory for more sales. The result would have been more profit earned on the same investment.

* * * * *

1. The rate at which an asset is converted to cash is called _____.

---

liquidity

---

2. Your accounts receivable are usually considered (MORE/LESS) liquid than your inventory.

---

MORE

---

3. More liquid assets are those that are converted to cash (MORE/LESS) rapidly.

---

MORE

---

4. Your investment in inventory is recovered when:

   a. the inventory is sold
   b. cash from the sale is received

---

b. cash from the sale is received

---

5. While goods remain in inventory, the capital invested in them is _____.

---

tied up

---

6. Turnover is a measure of the rate at which assets are converted to _____.

---

cash

---

7. The more rapidly your assets turn over, the more opportunities you have to invest for profit. (TRUE/FALSE)

---

TRUE

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* * * * *

## ASSET MIX

### Total Asset Limitations

If the total amount of assets available to you were unlimited, you would have little reason to be concerned about problems such as turnover or asset management. However, this is never the case.

The total assets available to any business are limited by the credit available to the business and the owners' equity in the business. Therefore, it is critical to the success of your business that your total assets available be distributed among the various asset accounts in such a way that you realize maximum utility from them.

If the distribution of the total assets of a business were such that there is no cash, the business would be faced with obvious problems since obligations to creditors could not be met.

At the other extreme, if the only asset of the business was cash, there would be little opportunity for profit other than earning interest in a savings bank.

Consider the distribution of assets shown below:

| | |
|---|---|
| Cash | $ 10,000 |
| Accounts Receivable | 20,000 |
| Inventory | 30,000 |
| Fixed Assets | 40,000 |
| Total Assets | $100,000 |

If the business used the $10,000 cash to acquire more inventory, inventory would be increased to $40,000 but cash would be reduced to $0 and the business would be unable to meet its obligations. Similarly, if a sudden sales increase of $10,000 built accounts receivable to $30,000, and inventory remained constant, being purchased only to replace items sold, the cash balance would again be reduced to $0.

### Distribution Problem

A fundamental problem of asset management is to distribute the total available assets among the various accounts in such a way that the business can accomplish the following:

- Have sufficient cash on hand to meet obligations to creditors.

- Carry a sufficient volume of accounts receivable to support credit sales.

- Have sufficient inventory on hand to provide customers with the goods they need.

- Have sufficient fixed assets to provide any buildings, machinery, or equipment that might be necessary for the conduct of the business' operation.

Striking a Balance

Your investment in any asset can be either too high or too low. An excess of any asset can create problems because capital is tied up and is not available for investment in other assets. A deficiency in any asset can lead to lost sales. The challenge is to seek an appropriate level for each asset to support sales without tying up capital needed for other assets or to meet obligations.

If a company establishes an overly restrictive credit policy in order to reduce accounts receivable, credit sales could be lost. On the other hand, if lax credit policies and collection procedures allow accounts receivable to become too high, the capital tied up in receivables would be unavailable for other, more profitable purposes.

If inventories are too low, the company may not have a sufficient assortment and quantity of merchandise available to support market demand. However, if inventories become too high, needed capital will be tied up.

Problems Related to Excess Assets

Besides tying up needed capital, excesses of assets can create a second major problem. Assets can lose their value. Accounts receivable may never be collected. Inventories may never be sold.

If accounts receivable are allowed to build through laxity in credit approvals and collection procedures, poor credit risks may lead to numerous bad debts.

If inventories are allowed to grow old, many items will lose their market value.

In either case, excesses caused by aging have tied up capital and caused assets to lose their value.

* * * * *

1. The total amount of assets available to a business is (LIMITED/UNLIMITED).

---

LIMITED

---

2. Since total assets are limited, particular attention must be paid to their distribution. (TRUE/FALSE)

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TRUE

---

3. Capital tied up in accounts receivable is unavailable for investment in other assets. (TRUE/FALSE)

---

TRUE

---

4. What problem would you associate with an inventory deficiency?

---

lost sales

---

5. Name two problems associated with an excessive inventory:

   1.
   2.

---

   Capital is tied up.
   Some items may lose their value.

---

6. Name two problems associated with excessive accounts receivable:

   1.
   2.

---

   Capital is tied up.
   Some accounts may never be collected.

---

* * * * *

## PROBLEM DETECTION

### Requires Management Attention

The problems of business are not self-healing. Without the attention of management, they tend to intensify. For example, if an excess of accounts receivable is ignored, and management fails to enforce collection policies, accounts receivable will probably grow out of proportion and some accounts may never be collected.

### Avoiding Problems

Many business problems can be avoided through sound policies that prevent them from occurring. Review of credit applications to eliminate bad credit risks and close attention to inventory purchases can help to minimize excesses in these accounts. However, even with vigorous pursuit of sound policies, some problems inevitably occur because management's control is not absolute.

A shift in the economic fortunes of customers can make slow payers out of apparently good credit risks. Merchandise acquired for inventory may generate little or no market demand.

To some extent, these problems can be controlled; but they cannot be eliminated. If the problems are recognized soon enough, however, management can take corrective action before they become too severe. Arrangements can be made with slow-paying customers. Inventories can be reduced through clearances before they lose their value altogether.

### How Are Problems Detected?

Problems are detected through analyses of various asset accounts and comparison with standards.

In this respect, the use of certain ratios is often helpful. A typical ratio is the average collection period for receivables. This ratio is calculated as follows:

| Accounts Receivable | ÷ | Average Daily Credit Sales | = | Average Collection Period |
|---|---|---|---|---|

For example, if your average daily credit sales are $100 and your outstanding accounts receivable are $4,500, your average collection period would be calculated as follows:

| Accounts Receivable | ÷ | Average Daily Credit Sales | = | Average Collection Period |
|---|---|---|---|---|

$4,500 ÷ $100 = Average Collection Period

45 days = Average Collection Period

This shows that, on the average, your customers are paying their bills in an average of 45 days. Is this good or bad? The answer lies in comparing your collection period with other guidelines.

Company Policy

One guideline might be the terms of payment that you specify in your customer billings. If you specify payment within 30 days, an average collection period of 45 days would indicate that, on the average, customers are slow in paying and corrective action should be taken.

Industry Standards

Frequently, ratios and other statistics can be compared with other businesses in your industry. In many industries, operating statistics for typical businesses within the industry are published periodically. These statistics report such factors as the average markup percentage, average expenses as a percentage of sales, and profit as a percentage of sales, as well as the distribution of various asset, liability, and net worth accounts. Such statistics are usually published separately for companies of various size within the industry. Often they highlight the operating averages of the most profitable companies in the industry so that these can be used as a standard by others.

By comparing your own operating statistics to industry norms, you can often get a good idea of areas of your operation that require improvement. For example, if you found that the average receivables for companies in your industry represent 30 days' sales, and yours are 45 days, you would realize that some improvement is necessary in your credit policies and collection procedures. You would also know that such an improvement is possible.

These operating statistics can usually be found through your trade association or your local public library.

## Comparison with Previous Periods

It is often useful to compare your current performance with your performance in previous periods. For example, if you found your average collection period increasing, you could reexamine your credit policies and collection procedures or become more diligent in pursuing them.

## Corrective Action

The techniques of analysis permit you to identify problems. As the owner/manager of a small business, your most important function is to correct the problem once it has been identified. Awareness of the problem is a critical first step, but it is not the solution to the problem.

* * * * *

1. Why is it important to detect problems as soon as possible?

---

So they can be corrected promptly before they become too severe.

---

2. Diligent adherence to company policies and procedures will eliminate all problems. (TRUE/FALSE)

---

FALSE (However, it can prevent many problems from occurring.)

---

3. You find that your average collection period is 60 days and the terms of sale specify payment within 30 days. This is an example of comparing an operating statistic with:

   a. an industry standard
   b. a company policy

---

   b. a company policy

---

4. You find that your average collection period is 60 days and typical businesses in your industry have a collection period of 52 days. This is an example of comparing a ratio or statistic with:

   a. a company policy
   b. an industry average
   c. previous performance

---

   b. an industry average

---

5. Besides company policy and industry averages, name one other guideline that can often be useful in comparing your current operating statistics.

---

   Your own performance in previous periods.

---

6. Problem detection is the solution to problem correction. (TRUE/FALSE)

---

   FALSE (But it is a critical first step that tells you where corrective action must be taken.)

---

* * * * *

## SUMMARY

This booklet was designed to introduce you to the general problems of asset management and to help you understand those problems that are fundamental to the control of all asset accounts. Individual assets will be explored in more detail in later booklets. In these booklets you will learn the following:

- How to control your accounts receivable at levels that will support your credit sales without becoming excessive so that capital is tied up and there is an increased possibility that some accounts may never be collected.

- How to control your inventory at levels that are adequate to support your sales demand without becoming excessive so that capital is tied up and some items in inventory may lose their value.

- How to minimize your investment in fixed assets so that you can enjoy the full advantages of using them with a minimum capital commitment and reduced exposure to the inherent risks of fixed asset ownership.



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